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ILLINOIS COMMERCE COMMISSION

DOCKET NOS. 02-0798/03-0008/03-0009 (Consolidated)

REBUTTAL TESTIMONY

OF

DAVID CROSS

Submitted On Behalf

Of

CENTRAL ILLINOIS PUBLIC SERVICE COMPANY

d/b/a AmerenCIPS

and

UNION ELECTRIC COMPANY

d/b/a AmerenUE

May, 2003

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Q. Please state your name and business address.

A. My name is David Cross. My business address is 1717 Arch Street, 27th Floor, Philadelphia, PA 19103.

Q. By whom are you employed?

A. I am employed by Mercer Human Resources Consulting as Principal and Senior Consultant.

Q. On whose behalf are you testifying?

A. I am testifying on behalf of Central Illinois Public Service Company d/b/a AmerenCIPS and Union Electric Company d/b/a AmerenUE, sometimes referred to as "Company," or collectively as the "Companies" or "Ameren".

Q. What is the purpose of your testimony?

A. The purpose of my rebuttal testimony is to respond to various assertions put forth by Illinois Commerce Commission ("ICC") Staff witness Burma Jones upon which she relies to disallow test year expenses associated with incentive compensation. In brief, I demonstrate that Ms. Jones is in error to suggest incentive compensation "is dependent upon financial goals of the Company that primarily benefit shareholders"; that "ratepayers would have provided funding [for the plan] even if no cost were incurred by the Company because plan goals were not met"; and that the "plan is discretionary and may be discontinued at any time;". (ICC Staff Exhibit 1.0, p. 14).

Q. Please provide a summary of your testimony.

A. My testimony addresses the appropriateness of the design, competitiveness, and payment of Ameren's incentive compensation plans compared to industry practices. I first cover the general standards of incentive design, then analyze how Ameren's plans compare to other plans across the utility industry. The primary objectives of an incentive plan are to attract, retain and motivate employees. In designing an incentive plan one should align two factors: 1) the incentive levels should be competitive in the labor markets in which the Company competes for talent, and 2) the plan should reflect the organization's unique business objectives. Ameren's incentive plans are consistent with these objectives and principles.

Ameren establishes aggressive goals for its incentive awards and holds employees accountable for meeting their expected level of performance. In addition, the practice of providing incentive compensation to employees at all levels of the organization is a competitive practice. My analysis of how Ameren's level of incentive compensation compares to plans across the utility industry indicates that it is at the average level for the market. The base salary plus the average incentive payout over the past three years indicates that Ameren is at 100% of the market median. As a result of the two factors being met, the Ameren plan accomplishes the important goal of enhancing tangible customer benefits, which Ameren witness Mark Lindgren explains in greater detail in this rebuttal testimony.

Q. Please describe Mercer's work in compensation assessment.

A. A compensation assessment typically involves the determination of competitive market rates for all elements of direct compensation. These elements include base salary, annual bonus, and long-term / equity incentives. This is generally done by benchmarking compensation data for client positions to compensation data reported for similar positions in published or proprietary compensation surveys. Mercer has a dedicated organization with expertise in market pricing positions and is a major provider of survey data.

Q. Please describe Mercer's work in reward strategy and incentive design.

A. A design project generally begins with an assessment of the organization, its priorities, labor market issues and performance. We use this understanding as a foundation for establishing the rationale and mechanics of an incentive plan. In our consulting, Mercer places a strong emphasis on pay-for-performance and on designing plans that will reward improvements in organizational performance. Hence, our initial understanding of the organization ensures we know how pay and performance should align with each unique organization. In this regard, I am sufficiently informed as to the organizational structure of Ameren and its incentive compensation plan.

Q. Please describe your background in compensation.

A. I am a Principal and Senior Consultant with Mercer and lead the Performance, Measurement and Rewards practice in our Princeton/Philadelphia office. I have been with Mercer for five years. While I work with clients across a wide spectrum of industries, I have an industry specialty working with utilities and energy service organizations, like Ameren. Prior to joining Mercer, I worked with a similar client base as a consultant with Towers Perrin, for five years. Towers Perrin is a competitor firm with a similar client profile to Mercer. The foundation of my utility expertise came through my experience prior to Towers Perrin when I worked for the Edison Electric Institute ("EEI") for six years. As the Manager of Human Resource Information for EEI, I managed and/or developed annual industry-wide compensation surveys including Executive Compensation, the Management Administrative & Professional ("MAP") Survey, the Non-Exempt Wage Survey, and the Collective Bargaining Survey. Some of the utility clients for whom I have conducted compensation projects include Potomac Electric Power Company, Arizona Public Service, Cinergy, Knoxville Utilities Board, Kansas City Power & Light, Omaha Public Power District and Peoples Energy.

Q. What are the objectives of an incentive program?

A. Organizations typically design incentive plans to meet objectives of attracting, retaining, and motivating employees. The opportunity to earn incentives can attract potential employees that the organization is interested in hiring as well as support the retention of current employees. Incentive programs can also motivate employees to focus on performance goals by linking payouts to specific measures. Incentive plans differ, depending on the character and relative importance of these performance goals.

Q. In your view, are there principles or standards of incentive design?

A. Yes. When Mercer designs an incentive plan we strive to align two factors: 1) incentive levels should provide a competitive opportunity, and 2) the plan should reflect the organization's unique business and financial objectives. Incentive design should balance appropriate incentive levels, defined by the organization's key markets for labor and the performance needs and expectations of the business. Without a clear understanding of this balance, an organization could potentially pay at an appropriate competitive position in the market, but if the company does not receive the benefits of improved performance, then arguably the incentives were not effective.

Q. How does an organization identify the appropriate labor market?

A. Organizations compete with each other for talent in the labor market. The appropriate labor market is a segment (e.g. defined by industry or geography) in which the organization directly competes for the skills and capabilities of people it needs to succeed operationally. Different employee groups exist in different labor markets. For example, the labor market for executive positions tends to be national, whereas the labor market for lower-level positions tends to be regional or local. In the case of utilities, an organization would likely compete for its line operational positions (e.g., gas line mechanics) against other utilities. Talent for staff positions in the finance and human resources areas is likely drawn from a wider cross-section of industries.

Q. How does performance factor into compensation analysis?

A. Incentive design must take into account the performance expectations of customers and investors. Performance measures and goals should reflect the strategic and financial objectives of these interests to support the on-going success of the business. One criterion used to assess whether performance measures are appropriate is whether other utilities are using similar measures. Therefore, companies should compare themselves to other companies providing similar products or services and similar levels of financial performance. A well-defined incentive plan can be a powerful tool in aligning the interests of employees (through financial incentives) and customers (through better performance). Understanding performance is therefore one of the fundamental elements of incentive design.

Q. Are there any other principles of incentive design that are important in your work?

A. Yes. An effective incentive plan design must create 'line-of-sight' for the participants. This means that the participants understand how they can influence the measures in the incentive plan. A highly complex plan may best reflect organizational performance, but for the plan to be effective, participants need to understand how they can impact the performance measure. There is often a tradeoff between selecting measures that are highly accurate versus measures that are simple and meaningful to participants. A good plan balances these considerations.

Q. Is Ameren's overall pay strategy reasonable?

A. Yes. Ameren defines competitiveness relative to the median or 50th percentile of the market for both base pay and incentive pay. This is a very reasonable strategy and in my consulting experience, is consistent with 90% of my clients. The other 10% are almost all above the median of the market.

Q. How do Ameren's pay levels compare to other utilities?

A. My assessment of Ameren's compensation levels for both salary and annual incentive payouts is that they are at a reasonable position with respect to the median of the market. Mercer considers a range of plus or minus 10% of the market median to be within the competitive range for a group of positions. Actual compensation levels typically differ from market rates due to the skills, experience and performance of the incumbent. Mercer assessed the base salary and total cash compensation (base salary plus annual incentives) for 16 Ameren benchmark positions representing 136 incumbents. The Ameren positions were matched to comparable utility positions in our own surveys plus other published and proprietary compensation survey data. While this is only a sample of all Ameren positions, in my view it represents a reasonable cross-section of functions and levels to lead to a general conclusion about the competitiveness of Ameren's salary and bonus structure. Based on this analysis, the Ameren benchmark positions are 106% of median market base salary. Total cash compensation using the average incentive payout over the past three years is 100% of market median.

In addition, Mercer compared Ameren's executive compensation levels to those reported in Securities Exchange Commission filings for a peer group of fifteen comparable utility companies with revenues ranging from approximately $2.4 to $8.5 billion. The compensation level of Ameren's Chief Executive Officer ("CEO") was compared to those of the peer group CEOs. All other Named Executive Officers were compared by rank (the second-highest paid Ameren executive in terms of total cash compensation was compared to the second-highest paid executive in the peer companies). Ameren's executive compensation levels were substantially below market. For the group as a whole, base salary was 92% of the peer group median with significant variation among positions. The CEO's base salary was 101% of the peer group median with all other executives below the median. Two of the executives had base pay that was less than 85% of the peer group median for their positions. Ameren's overall total cash compensation (salary plus annual incentives) was 70% of the peer group. None of the executives was above 76% of market. These levels are substantially below market, primarily because Ameren executives received lower annual incentive payouts than their peers.

Q. What did you observe in your examination of Ameren's incentive awards?

A. When an organization designs an incentive plan it establishes target or expected performance goals and target incentive levels that are paid if that level of performance is achieved. However, since the award is contingent on performance, it is not guaranteed. If an incentive plan is calibrated properly, it provides employees with the opportunity to earn competitive compensation for achieving the desired level of performance for the organization and customers. Properly calibrated incentive plans are key tools in developing a performance oriented culture for the organization. With respect to Ameren, we observed that actual payouts for all but one of the incumbents in the benchmark positions were below target during the three years under review. For all benchmark positions, payouts averaged 54% of the target incentive level during the test year. In effect, the payout average tells us that Ameren established aggressive goals for their incentive awards and held incumbents accountable for meeting the expected level of performance. Furthermore, if incentives continued to be paid below target, it would suggest one of two things. First, Ameren has a pattern of establishing higher standards in its incentive plans than its peers. Second, since incentive awards are calibrated to the market at target, then Ameren's cash compensation is actually below market – since the probability of Ameren employees achieving the target award is less than average.

Q. If Ameren did not pay incentives at all, how would its compensation compare to market?

A. It would be below market and Ameren would likely experience difficulty attracting and retaining quality employees. For the benchmark positions we examined, Ameren's compensation would still be 106% of market base salary but would fall to 93% of market total cash compensation. This is why Ms. Jones' undue emphasis as to the possibility the plan may be discontinued at any time rings hollow. Incentive compensation is a critical part of Ameren employees' wage and benefit package. If a company was to arbitrarily discontinue its plan, this would have a detrimental impact on employee morale, and bear negatively on its ability to attract and retain employees. In addition, discontinuing incentives would put a significant burden on the organization to maintain and build a talented workforce in a market where incentive compensation is a necessary element of an employee's total remuneration package. In short, providing incentive compensation is a cost of doing business similar to base salary, pension and health benefits.

Q. Ms. Jones relies upon statements in the plans indicating that they may or may not be continued. How do you respond?

A. My judgment as to the propriety of the Ameren incentive compensation plans is not swayed by the fact management reserved the right to discontinue the plans. I am advised by counsel there are legal ramifications associated with such statements. Nevertheless, I cannot foresee at this time, in this marketplace, where it would be prudent for Ameren to discontinue the incentive compensation plans. The labor market implications of such an action would suggest to current and future employees that the opportunity to earn incentives is an empty promise which would have a significant backlash effect on the Company's ability to retain and attract employees, to say nothing of the fact that employee morale would be undermined.

Q. If the incentive bonuses were put into base salary, would that help ensure the attraction and retention of employees?

A. It might, but there is a flaw to that approach. Based on the benchmark positions I examined, by moving all incentive opportunity into base salary Ameren's overall market position would be at 115% of market base salary using average actual payouts over the past three years (by definition, total cash compensation would remain at 100% of median – just all delivered through base salary). However, this approach would in effect guarantee 100% of each employee's portion of compensation and would fail to support one of the basic tenets of compensation design – aligning pay with performance. In such a context, Ameren would eliminate the leveraged portion of its pay program, which would not be in the interests of either Ameren's customers or its shareholders.

Q. Ms. Jones argues that "ratepayers would have provided funding even if no cost were incurred by the Company because plan goals were not met;". (ICC Staff Exhibit 1.0, p. 14). Do you agree with this statement?

A. No, assuming I understand her point. I believe Ms. Jones is stating the goals or objectives of a plan may not be met and so the incentive compensation may not be paid to the employee, but the Companies' rates will still reflect this expense. She operates from the premise that if the plan failed to pay out, then it has no benefit to customers, or that Ameren will not elect to pay the incentive compensation.

Ms. Jones' response does not reflect the fundamental underpinnings of incentive compensation plans. They are not designed to fail, nor are they designed to pay out 100% of the incentive all of the time; they are intended to enhance employee performance by providing a set of performance standards and to deliver competitive levels of incentive compensation for achieving those standards. The fact that, if incentives were included rates, funding would still be provided does not mitigate the overall objectives of the incentive plan – to communicate key objectives for the organization which ultimately drives performance. This is beneficial for Ameren's customers and shareholders. Moreover, as previously mentioned, only 54% of the target incentive level was paid by the Companies during the test year for this case. That level of payout is clearly a conservative representation of what the Companies can expect to pay in the future under the Ameren plan.

Ameren's management wants these plans to work. These plans can only work if the stated goals and objectives are met and the incentive compensation is paid. Ms. Jones' position the utility could recover incentive compensation expense in rates but then not pay out the compensation, is not grounded in market reality.

Q. How prevalent are incentive plans throughout the utility industry?

A. According to Mercer and other survey sources, the majority of utilities provide some type of variable pay program. Our surveys indicate that over 80% of utilities provide incentive plans for executives and approximately 2/3 have incentive programs covering a broader employee population. Even public power organizations often provide incentives, which suggests that incentive plans are considered to be in the public interest. A custom survey conducted by Mercer of selected members of the Large Public Power Council found that over 50% of public power organizations have a bonus program.

Q. How does Ameren's incentive opportunity or target compare with those seen in other utility companies?

A. Ameren's incentive levels are comparable to those seen in the utility industry. Under the Executive Incentive Plan, incentive opportunity ranges from 20% of salary for the manager level to 60% for the CEO of Ameren. Mercer surveys indicate the median target for utility executives is 25% to 50% of base salary. Ameren's Management Incentive Plan, which covers management and salaried employees, provides targeted award opportunities of 6% to 10% of base salary. According to Mercer surveys, median targets for the utility industry range from 8% of salary for clerical and technical employees to 13% for management employees. The Ameren Incentive Plan, which covers bargaining unit employees, provides a target of 3% of salary and a maximum of 4.5%. (I understand this particular plan was suspended in the year 2003.) For hourly employees in the utility industry, the median target incentive is 5% of base salary.

Q. Ameren's incentive plans are structured by funding a pool based on earnings and then allocating the awards based on other measures of performance. Is this typical and what comments would you have about such a design?

A. Based on our survey information, earnings based measures such as used in the Ameren plans are the most common sets of measures used in annual incentive plans. Among companies in general industry the prevalence is over 60 percent; the prevalence of earnings based measures among utilities is similar. What is different about the Ameren plan is that the earnings measure really just 'funds' the incentive dollars. Allocation of the awards is based on other measures that are directly aligned with customer interests. In this regard, Ms. Jones' claim that the incentive compensation plan is dependent on Ameren meeting financial goals misses the mark. In addition, I would suggest that in its current state, the Ameren plan is more challenging than other plans because of the two sets of hurdles that have to be achieved: 1) fund the plan through earnings performance, and 2) achieve performance expectations among several other measures.

Q. How does performance based on these measures benefit Ameren's Illinois customers?

A. Actual payouts depend on business line or individual performance. Business line performance is measured against pre-defined Key Performance Indicators. Key Performance Indicators include goals such as improving system reliability, reducing delivery service cost per customer, and increasing customer satisfaction that benefit customers, contrary to Ms. Jones' belief. Providing incentives that support the reduction of costs and improved customer service is ultimately in the interest of Ameren's customers. According to a relatively recent article in *Public Utilities Fortnightly*, customer satisfaction is critical for utility companies and it tends to be a leading indicator of financial performance. The article further notes that a study of best practices concerning customer satisfaction concluded that firms with progressive programs tie customer satisfaction measures to compensation at all levels of the organization. In addition, if Ameren is able to attract and retain a high quality workforce that continues to improve upon these measures, then this also benefits customers. Incentive plans benefit customers by motivating employees to focus on key measures of interest to customers and by promoting a stable workforce.

As I stated, Ameren uses earnings per share to fund its incentive pools. Incentive pools are often funded by earnings per share or another earnings measure. Business unit performance and individual performance are also common plan measures. Contrary to Ms. Jones' conclusions surrounding the attainment of financial performance goals, enhancing the utility's EPS is a clear benefit to customers. Enhancing the EPS can occur by reducing costs; utility costs are recovered in rates; reducing costs thus directly benefits customers taking service under these rates. Further, a utility that is able to reduce or hold the line on its costs, is better able to avoid seeking rate relief.

Q. What is your view of the plans' provisions for excluding non-recurring or extraordinary items?

A. This too is common practice. I mentioned that a key principle in incentive design is the need to balance line-of-sight with financial accuracy. For an incentive plan to be an effective motivational tool, participants must understand how they can impact performance. Extraordinary items are by their nature difficult or impossible for most

Ameren employees to influence. Management needs flexibility to ensure that employees are not penalized for making a decision that prevents meeting the short-term earnings goal but is appropriate for the long-term viability of the business. A plan that allows some flexibility for non-recurring events and items such as large capital investments ultimately benefits customers, because it encourages employees to make correct business decisions without concern about the impact on award payouts.

Q. Thus far you have focused on incentives in utilities. How common are incentives in general industry?

A. According to Mercer and other survey sources, a significant majority of organizations provide some type of variable pay program. Executive and management incentive programs are provided by approximately 80% of organizations with between 5,000 and 10,000 employees. Approximately 60% of organizations include professional/technical employees and over 40% include clerical and hourly employees.

Q. How do Ameren's incentive targets compare with those seen in general industry?

A. Ameren's incentive levels are generally lower than those seen across industry. The median target percentage of base salary is 35% for executives and 15% for management. Targets for professional/technical employees are typically 10% of salary. Clerical hourly employees typically have targets of 5% of salary. These targets are all generally higher than Ameren's targets.

Q. In light of your industry knowledge, what is your view of Ameren's incentive plans in serving the interests of the customer and the organization?

A. In my view, Ameren's incentive programs benefit customers as well as shareholders and employees. The level and structure of Ameren's incentives are reflective of market practice. Moreover, incentive compensation sends an important and necessary message to Ameren employees. The utility industry is experiencing a time of unprecedented change and companies face new pressures on multiple fronts. Utilities are striving to find ways to provide superior service to customers while reducing cost. The industry is consolidating, and a number of utilities are undergoing mergers or acquisitions. Further, volatility in energy supply and demand has created price swings that require utilities to become savvy in finding the most effective way to deliver energy to customers. These changes make it more important than ever for utilities to attract and retain quality talent at a time when non-regulated energy organizations are often providing premium compensation levels for key employees. To survive in this changing environment, utilities are working to foster an even stronger performance orientation. Incentives that promote sound fiscal management and customer satisfaction can help create a stronger Ameren, which ultimately benefits customers.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does